DEPARTMENT OF STATE REVENUE

04-20091023.LOF

Letter of Findings: 04-20091023
Sales and Use Tax
For Tax Years 2006 and 2007

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ISSUES

I. Sales and Use Tax – Exemptions.

Authority: IC § 6-2.5-1-1 et seq.; IC § 6-2.5-3-4; IC § 6-2.5-5-3; IC § 6-2.5-5-5.1; IC § 6-2.5-5-9; IC § 6-8.1-5-1; 45 IAC 2.2-4-1; 45 IAC 2.2-4-2; 45 IAC 2.2-4-27; 45 IAC 2.2-5-8; 45 IAC 2.2-5-11; 45 IAC 2.2-5-12; 45 IAC 2.2-5-16; Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue, 867 N.E.2d 289 (Ind.Tax Ct. 2007); Indiana Dept. of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96 (Ind. App. 1974); Indiana Dept. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind.1983); Rotation Products Corp. v. Department of State Revenue, 690 N.E.2d 795 (Ind.Tax1998); Mumma Bros. Drilling Co. v. Department of Revenue, 411 N.E.2d 676 (Ind. App. 1980); General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind.Tax1991); Department of Revenue v. U. S. Steel Corp., 425 N.E.2d 659 (Ind. App. 1981); Indiana Dept. of State Revenue v. Harrison Steel Castings Co., 402 N.E.2d 1276 (Ind. App. 1980). Sales Tax Information Bulletin 8 (May 2002), 25 Ind. Reg. 3934.

Taxpayer protests the assessment of tax on purchases of tangible personal property.

II. Tax Administration – Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer, an Indiana company, manufactures components for various industries. The Indiana Department of Revenue ("Department") conducted a Sales/Use tax audit for tax years 2006 and 2007. Due to the volume of Taxpayer's records, the Department and Taxpayer agreed to use a sample selected from Taxpayer's records and a projection method to perform the audit. Taxpayer, however, did not agree with the outcome of the projection. On the grounds that the projection result was the best information available at the time of the audit, the Department proceeded to assess Taxpayer use tax on the purchases, which Taxpayer did not pay sales tax, and/or did not self-assess and remit the use tax to the Department.

Taxpayer protests the imposition of use tax on some of the items. Taxpayer states that these protested items are exempt for several reasons. Taxpayer also protests the imposition of the ten percent negligence penalty. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Sales and Use Tax – Exemptions.

DISCUSSION

The Department's audit assessed Taxpayer use tax on purchases of tangible personal property. Taxpayer claimed that it was entitled to the manufacturing exemptions on several purchases of tangible personal property. Taxpayer also claimed that payments for services rendered were not subject to sales and/or use tax.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax 2007).

Indiana imposes a sales tax on retail transactions and a complementary use tax on tangible personal property that is stored, used, or consumed in the state. IC § 6-2.5-1-1 et seq. Generally, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly or finishing of tangible personal property are taxable. 45 IAC 2.2-5-8(a). An exemption from use tax is granted for transactions where the gross retail tax ("sales tax") was paid at the time of purchase pursuant to IC § 6-2.5-3-4. There are also additional exemptions from sales tax and use tax. A statute which provides a tax exemption, however, is strictly construed against the taxpayer. Indiana Dept. of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96 (Ind. App. 1974).

A. Manufacturing Exemptions.

The Department's audit assessed Taxpayer use tax on its purchases of tangible personal property, including, but not limited to, gauges, micrometers, conveyor systems, and chutes because Taxpayer failed to pay sales tax or self-assess and remit to the Department the use tax due. Taxpayer, to the contrary, claimed that it was entitled to the manufacturing exemptions.

IC § 6-2.5-5-3(b) states:

Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it **for direct use in the direct production, manufacture**,

fabrication, assembly, extraction, mining, processing, refining, or finishing **of other tangible personal property**. (**Emphasis added**).

IC § 6-2.5-5-5.1(b) provides:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it **for direct consumption as a material to be consumed in the direct production of other tangible personal property** in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture. (**Emphasis added**).

Thus, the Legislature has granted Indiana manufacturers a sales tax exemption for certain purchases, which are for "direct use in direct production, manufacture... of other tangible personal property." In enacting the exemption, the Legislature clearly did not intend to create a global exemption for any and all equipment which a manufacturer purchases for use within its manufacturing facility. "Fairly read, the exemption was meant to apply to capital equipment that meets the 'double direct' test." Mumma Bros. Drilling Co. v. Department of Revenue, 411 N.E.2d 676, 678 (Ind. App. 1980). The capital equipment "in order to be exempt, (1) must be directly used by the purchaser and (2) be used in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of tangible personal property." Indiana Dept. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520, 525 (Ind. 1983). "The test for directness requires the equipment to have an 'immediate link with the product being produced." Id. Accordingly, the sales tax exemption is applicable to that equipment which meets the "double direct" test and is "essential and integral" to the manufacture of taxpayer's tangible personal property. General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399, 401 (Ind.Tax,1991). The application of Indiana's double-direct manufacturing exemptions often varies on a determination of when a taxpayer's manufacturing process is considered to have begun.

An exemption applies to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. 45 IAC 2.2-5-8(a). Machinery, tools, and equipment are directly used in the production process if they have an immediate effect on the article being produced. 45 IAC 2.2-5-8(c). A machine, tool, or piece of equipment has an immediate effect on the product being produced if it is an essential and integral part of an integrated process that produces the product. Id. An integrated process is one where the total production process is comprised of activities or steps that are functionally interrelated and where there is a flow of "work-in-process." 45 IAC 2.2-5-8(c), example 1.

45 IAC 2.2-5-8(k) describes direct production as the performance of an integrated series of operations which transforms the matter into a form, composition or character different from that in which it was acquired, and that the change must be substantial resulting in a transformation of the property into a different and distinct product.

The exemption for direct use in production is further explained at 45 IAC 2.2-5-11, in part, as follows:

(a) The state gross retail tax shall not apply to sales of tangible personal property to be directly used by the purchaser in the direct production or manufacture of any manufacturing or agricultural machinery, tools, and equipment described in IC 6-2.5-5-2 or 6-2.5-5-3 [IC 6-2.5-5-3].

(b) The exemption provided in this regulation [45 IAC 2.2] extends only to tangible personal property directly used in the direct production of manufacturing or agricultural machinery, tools, and equipment to be used by such manufacturer or producer.

(c) The state gross retail tax shall not apply to purchases of tangible personal property to be directly used by the purchaser in the production or manufacturing process of any manufacturing or agricultural machinery, tools, or equipment, provided that the machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect upon the article being produced or manufactured. The property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

(d) For the application of the rules [subsections] above, refer to Regs. 6-2.5-5-3 [45 IAC 2.2-5-8 through 45 IAC 2.2-5-10] with respect to tangible personal property used directly in the following activities:

pre-production and post-production activities; storage; transportation; tangible personal property which has an immediate effect upon the article produced; maintenance and replacement; testing and inspection; and managerial, sales, and other nonoperational activities.

The exemption for direct consumption in production is further explained at 45 IAC 2.2-5-12, in part, as follows:

(a) The state gross retail tax shall not apply to sales of any tangible personal property consumed in direct production by the purchaser in the business of producing tangible personal property by manufacturing, processing, refining, or mining.

(b) The exemption provided by this regulation [45 IAC 2.2] applies only to tangible personal property to be directly consumed in direct production by manufacturing, processing, refining, or mining. It does not apply to machinery, tools, and equipment used in direct production or to materials incorporated into the tangible personal property produced.

(c) The state gross retail tax does not apply to purchases of materials to be directly consumed in the production process or in mining, provided that such materials are directly used in the production process; i.e., they have an immediate effect on the article being produced. The property has an immediate effect on the

article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

45 IAC 2.2-5-8(d) states:

Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

45 IAC 2.2-5-8(f) provides:

(1) Tangible personal property used for moving raw materials to the plant prior to their entrance into the production process is taxable.

(2) Tangible personal property used for moving finished goods from the plant after manufacture is subject to tax.

(3) Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process.

(4) Transportation equipment used to transport work-in-process, semi-finished, or finished goods between plants is taxable, if the plants are not part of the same integrated production process.

45 IAC 2.2-5-8(g) further states:

"Have an immediate effect upon the article being produced": Machinery, tools, and equipment which are used during the production process and which have an immediate effect upon the article being produced are exempt from tax. Component parts of a unit of machinery or equipment, which unit has an immediate effect on the article being produced, are exempt if such components are an integral part of such manufacturing unit. The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean that the property "has an immediate effect upon the article being produced". Instead, in addition to being essential for one of the above reasons, the property must also be an integral part of an integrated process which produces tangible personal property.

Accordingly, Taxpayer's manufacturing process began when the equipment operated to make the parts/components for its customers.

1. Testing and Inspection Equipment.

Taxpayer claims that it was entitled to the manufacturing exemption on its purchases of "gauges, micrometers and other types of tools and equipment used to test and inspect manufactured parts produced for sale" pursuant to 45 IAC 2.2-5-8(i). Specifically, Taxpayer states, in relevant part:

Testing and inspection and quality assurance occurs at various stages of the production process, most notably in the "Hold Department." Parts are loaded into large baskets and totes and transported to this area via a forklift assigned to this department. The parts are tested, inspected, and sorted prior to additional processing. Rejected parts are processed and/or reworked to meet product specifications. Accepted parts are processed further as required. Since the production process is not complete until the product is in its completed form and packaged, this equipment qualifies for exemption because it is testing and inspecting semi-finished goods as part of the integrated production process.

The documentation Taxpayer provided in support of its protest, however, failed to demonstrate that the "gauges" and "other types of tools and equipment" were directly "used to test and inspect manufactured parts produced" during its manufacturing process. Rather, Taxpayer's documentation demonstrated that "micrometers" and "gauges" were used to make machines in preparation for the manufacturing process. Thus, the use of the micrometers and gauges was "pre-production."

In short, Taxpayer failed to provide sufficient documentation to support its claim. Since Taxpayer did not pay sales tax at the time of the purchase, use tax was properly imposed.

2. Conveyor Systems and Chutes.

Taxpayer claimed that, pursuant to 45 IAC 2.2-5-8(c), example 1, it was entitled to manufacturing exemption on its purchases of "conveyor systems, chutes and repair parts used to move parts from one work station to another, which are used to transport the parts to other areas of the plant for further processing." Taxpayer maintained that the scrap materials are conveyed into hoppers and transported via fork trucks and delivered to shipping as a finished product for sale.

45 IAC 2.2-5-8(c), in pertinent part, states:

The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are **directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.** (**Emphasis added**).

--EXAMPLES--

(1) Aluminum pistons are produced in a manufacturing process that begins, after the removal of raw aluminum from storage inside the plant, with the melting of the raw aluminum and the production of castings

in the foundry; continues with the machining of the casting and the plating and surface treatment of the piston; and ends prior to the transportation of the completed pistons to a storage area for subsequent shipment to customers. Because of the functional interrelationship of the various steps and the flow of the work-in-process, the total production process, comprised of such activities, is integrated.

The Indiana Tax Court has provided explanation of the manufacturing exemption in Rotation Products Corp. v. Department of State Revenue, 690 N.E.2d 795 (Ind.Tax1998), where the taxpayer was engaged in remanufacturing ball bearings. In that case the court explained:

Cave Stone's approach to the industrial exemptions has been applied to cases where the question was whether a product was created. For example, in Harlan Sprague Dawley, this Court drew from the teaching of Cave Stone in concluding that specially bred laboratory rats were products: "In the context of the industrial exemptions, production is viewed expansively as all activity directed to increasing the number of scarce economic goods." Harlan Sprague Dawley, 605 N.E.2d at 1228 (quoting Cave Stone, 457 N.E.2d at 524) (internal quotation marks omitted). The laboratory rats were scarce economic goods. Laboratories used them for specialized research, and the rats were much more suitable for that research than their naturally occurring counterparts. Consequently, this Court found that they were products and held that the taxpayer was entitled to the industrial exemptions.

Id. at 799.

The court further explained:

Subsequent case law has reemphasized Harlan Sprague Dawley's focus on whether a product was created. In Mechanics Laundry & Supply, Inc. v. Dep't of State Revenue, 650 N.E.2d 1223 (Ind. Tax Ct. 1994), this Court evaluated whether the laundering of textiles constituted processing in the context of the industrial exemptions. In concluding that it did not, this Court found that the laundering of soiled textiles merely "perpetuated textiles that were produced by others." Id. at 1230 (citing Undercofler v. Macon Linen Serv., Inc., 114 Ga. App. 231, 241, 150 S.E.2d 703, 709 (1966)). See also Indiana Waste Sys. v. Dep't of State Revenue, 633 N.E.2d 359 (Ind. Tax Ct. 1994) (taxpayer not entitled to exemption where taxpayer compressed garbage but did not produce other tangible personal property). Because the taxpayer in Mechanics Laundry produced no new tangible personal property, it was not entitled to the industrial exemption.

In Mid-America Energy Resources, this Court held that a taxpayer who chilled water for use in customers' air conditioning systems was entitled to an exemption for equipment used and materials consumed in the production of the chilled water. This Court focused its inquiry on whether the taxpayer's operation created a marketable good. "When goods are not produced, and a service is provided, the [industrial] exemptions are properly denied." (Internal citation omitted).

Id. at 799-80.

The court further provided:

The case law reveals three factors germane to this fact-sensitive inquiry. The first is an adaptation of the requirement of a substantially different end product: the substantiality and complexity of the work done on the existing article and the physical changes to the existing article, including the addition of new parts. The other two factors derive from the observations of the courts dealing with this issue: a comparison of the article's value before and after the work, and how favorably the performance of the remanufactured article compares with the performance of newly manufactured articles of its kind. Additionally, this Court concludes that another factor is applicable to this inquiry: whether the work performed was contemplated as a normal part of the life cycle of the existing article. This additional factor will prevent work that merely perpetuates existing products from qualifying for an industrial exemption. See Mechanics Laundry, 650 N.E.2d at 1230.

Id. at 802-3.

Finally, the court explained:

Finally, an analysis of the fourth factor favors RPC as well. Even if cleaning and polishing are a normal part of a roller bearing's life cycle (i.e., routine maintenance), it cannot be said that grinding away the load bearing surfaces of the roller bearing and replacing the roller cages and rolling elements are a normal part of that life cycle. (When RPC's customers bring the non-functional bearings to RPC, they do not know whether the bearings can be salvaged at all.) This is to be contrasted with the shirts at issue in Mechanics Laundry. Shirts are bought with the expectation that they will be washed again and again. No such expectation attaches to the purchase of roller bearings.

Id. at 803-4.

The court concluded that the taxpayer in that case was entitled to the exemption since its activities resulted in an essentially new product which went beyond the expected life cycle of the ball bearings as originally produced.

In this instance, Taxpayer's documentation demonstrates that the conveyor systems and chutes are used to transport scrap which was the by-product of its manufacturing process after the parts were made. Unlike the activities in Rotation Products, Taxpayer's use of the conveyer systems and chutes did not result in a product which goes beyond the expected life cycle of the scrap. Rather, Taxpayer used the conveyor systems and chutes to transport the scrap. The scrap was a by-product of Taxpayer's manufacturing process and the use of the

conveyer systems and chutes was "post-production."

Since Taxpayer did not pay sales tax at the time of the purchase, use tax was properly imposed.

3. Forklifts.

The Department's audit determined that one of its forklifts used in the "Hold Department" was not exempt and assessed use tax accordingly. Taxpayer claimed that it used the forklift one hundred (100) percent in moving semi-finished goods in and out of the Hold Department for further processing. Referring to 45 IAC 2.2-5-8(f)(3), Taxpayer claimed that it was entitled to the manufacturing exemption for the use of that forklift in the "Hold Department." Thus, the issue here is whether the particular forklift cited was within or without Taxpayer's production process. Taxpayer asks that the Hearing Officer second-guess the determination of the auditor who had the advantage of visiting Taxpayer's manufacturing facility, touring the production process, hearing an explanation of that process directly from Taxpayer's personnel, and witnessing first-hand the manner in which the forklift was used. The documentation Taxpayer has provided does not overcome this bar.

Since Taxpayer did not pay sales tax at the time of the purchase, use tax was properly imposed.

4. Safety Equipment and Apparel.

Taxpayer claims that it was entitled to the manufacturing exemption on its purchases of emergency shut-off switches, gloves, glasses, ear plugs, and shields because those items were used to protect its employees' safety pursuant to 45 IAC 2.2-5-8(c), example (2)(F).

45 IAC 2.2-5-8(c) states:

> The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.
>
> --EXAMPLES--
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> ...
>
> (2) The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt. The fact that such equipment may not touch the work-in-process or, by itself, cause a change in the product, is not determinative.
>
> ...
>
> (F) **Safety** clothing or **equipment which is required to allow a worker to participate in the production process without injury** or to prevent contamination of the product during production. (**Emphasis added**).

In Department of Revenue v. U. S. Steel Corp., 425 N.E.2d 659 (Ind. App. 1981), the appellate court affirmed the trial court's findings, in favor of the taxpayer, U.S. Steel Corp., that it was entitled to the manufacturing exemption concerning its purchases of personal protective equipment, including, but not limited to, prescription safety eyeglasses, protective mittens, hardhats, goggles, masks, hoods, jackets and aprons. The U.S. Steel court refined the application of the "double direct standard" illustrated in Indiana Dep't of State Revenue v. Harrison Steel Casting, 402 N.E.2d 1276 (Ind. App. 1980) and focused on "whether the safety equipment is an integral part of manufacturing and operates directly on the product during production."

Acknowledging that the "U.S. Steel's safety equipment was one of the tools used by workers to accomplish the job," The U.S. Steel court concluded that:

> Since steel can be made only because shielded workers deal directly with the raw materials of the product, the shields not only protect the worker but are a part of manufacturing which operates directly on the product during production.

U.S. Steel, 425 N.E.2d at 664.

As 45 IAC 2.2-5-8(g) explains, however, "[t]he fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean that the property has an immediate effect upon the article being produced." (Internal quotation marks omitted).

In this instance, Taxpayer explained that it installed the "emergency shut-off switches installed on the equipment and conveyors" to prevent injury. Thus, the emergency shut-off switches were intended to enable workers to stop the manufacturing process due to an emergency–in other words, after the unsafe event has occurred–not to allow its workers to continue participating in the manufacturing process. Taxpayer's documentation, thus, failed to demonstrate that the emergency shut-off switches are "required to allow a worker to participate in the production process without injury" and "an integral part of manufacturing and operate directly on the product during production" outlined in U.S. Steel.

According to Taxpayer's documentation, some of the employees, but not all of them, wear gloves to participate in the manufacturing production at Taxpayer's facility. Thus, Taxpayer's documentation also failed to show that Taxpayer's purchases of the gloves for the employees' use are "required to allow a worker to participate in the production process without injury" and "an integral part of manufacturing and operate directly on the product during production" outlined in U.S. Steel.

Taxpayer's documentation, however, demonstrated that its manufacturing process produced excessive noise

and, possibly, debris, which could injure its employees during production. Specifically, Taxpayer's documentation demonstrated that its employees must wear safety glasses and ear plugs at various areas to prevent injury during the manufacturing process. Thus, Taxpayer's purchases of the safety glasses and ear plugs for those employees' use are "required to allow a worker to participate in the production process without injury" and "an integral part of manufacturing and operate directly on the product during production" outlined in U.S. Steel.

In short, Taxpayer is entitled to manufacturing exemption on its purchases of safety glasses and ear plugs. Taxpayer, however, failed to demonstrate that it is entitled to manufacturing exemption on its purchases of emergency shut-off switches and gloves.

5. Machinery and Equipment Repair and Replacement Parts and Supplies.

Taxpayer claimed that it was entitled to the manufacturing exemptions on purchases of various repair and replacement parts to production machinery and equipment, and production supplies that were consumed in production. Specifically, Taxpayer maintains that the manufacturing exemptions were applicable concerning its purchases for the following items:

- [E]lectrical repair parts for production machinery and equipment, cut-off saws to cut and etch parts, drill bits, grinders, sanders, sandpaper, brushes, deburring supplies used for deburring and finishing operations, and a label maker used to produce labels affixed to specificity parts and sub-assemblies.
- [D]rills, drill bits, taps, milling equipment, grinding equipment, and other supplies used in development and production of tools and equipment.
- [E]quipment and supplies such as mineral spirits and detergents used to clean parts during the production process, indicating lights for production equipment, clamp sets for holding parts, servo pins used in machines, air tools and hoses used in assembly and production, Freon used to repair a chiller used for production, and other various parts and supplies used and consumed directly in the integrated production process.

As discussed above, manufacturing exemptions only apply to the items which are directly used in direct production and must have the immediate impact on the tangible personal property being produced. The Department's audit noted, in relevant part, as follows:

- The purchase of items that are related to the manufacturing process but do not have a direct impact on the item being produced are not included in the manufacturing exemptions....
- Cleaning equipment and solutions used to maintain tools and other equipment are not included in the manufacturing exemption for consumables. In the sample mineral spirits were purchased exempt from tax; at one point the mineral spirits were used to dilute the oil used in cooling the parts during the production process. As discussed with an operation manager the mineral spirits are no longer used for this purpose, they are only used as a cleaning solution in the tool room. Some invoices for parts cleaners were exempted at 50 [percent] since they were used to clean manufactured parts prior to packaging and to clean equipment. The cleaning of parts prior to packaging is an exempt activity and the cleaning of the equipment is not exempt as it is a maintenance function. The cleaners that are used for routine maintenance of the equipment are not exempt....
- The material portion of a repair to tangible personal property or to real property is subject to use tax. Items such as rip rap, Freon for an AC repair, paint and concrete patch kits were used by the taxpayer for maintaining the facility and not in direct manufacturing.

Taxpayer's photos identified what the items are, but failed to demonstrate that those items were directly used or directly consumed in its manufacturing process. Taxpayer asked that the Hearing Officer second-guess the determination of the auditor who had the advantage of visiting Taxpayer's manufacturing facility, touring the production process, hearing an explanation of that process directly from Taxpayer's personnel, and witnessing first-hand the manner in which the items were used. The documentation Taxpayer has provided does not overcome this bar. Since Taxpayer's purchases of the tangible personal property were subject to sales/use tax, so was the charge of freight.

In short, upon reviewing Taxpayer's documentation, the Department is not able to agree that Taxpayer has demonstrated that it directly used those items in direct production.

6. Non-returnable Packaging and Wrapping Materials.

Taxpayer claimed that it purchased "doubled sided film tape" to be used to seal packaging of finished goods for shipment to customers and, thus, was entitled to the exemption pursuant to IC § 6-2.5-5-9 and 45 IAC 2.2-5-16.

IC § 6-2.5-5-9(d) states:

Sales of wrapping material and empty containers are exempt from the state gross retail tax if the person acquiring the material or containers acquires them for use as nonreturnable packages for selling the contents that he adds.

45 IAC 2.2-5-16, in pertinent part, states:

(a) The state gross retail tax shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added, and returnable containers containing contents sold in a sale constituting selling at retail and returnable containers

sold empty for refilling.

...

(c) The receipt from a sale by a retail merchant of the following types of tangible personal property are exempt from state gross retail tax:

(1) Nonreturnable containers and wrapping materials including steel strap and shipping pallets to be used by the purchaser as enclosures for selling tangible personal property.

Taxpayer's documentation illustrated its use of the "doubled sided film tape," and stated that the purchased item was "[f]ilm tape attached to work in process part to adhere insulation production part." Based on its explanation, Taxpayer's purchase of the "doubled sided film tape" was not used for "wrapping materials" purpose, and, therefore, was not entitled to the exemption pursuant to the above statute and regulation.

B. Services.

The Department's audit assessed use tax on several transactions, which Taxpayer claimed were services. Taxpayer further maintained that its payments for services rendered were not subject to sales/use tax pursuant to 45 IAC 2.2-4-2(a).

45 IAC 2.2-4-2 states:

(a) Professional services, personal services, and services in respect to property not owned by the person rendering such services are not "transactions of a retail merchant constituting selling at retail", and are not subject to gross retail tax. Where, in conjunction with rendering professional services, personal services, or other services, the serviceman also transfers tangible personal property for a consideration, this will constitute a transaction of a retail merchant constituting selling at retail unless:

(1) The serviceman is in an occupation which primarily furnishes and sells services, as distinguished from tangible personal property;

(2) The tangible personal property purchased is used or consumed as a necessary incident to the service;

(3) The price charged for tangible personal property is inconsequential (not to exceed 10 [percent]) compared with the service charge; and

(4) The serviceman pays gross retail tax or use tax upon the tangible personal property at the time of acquisition.

(b) Services performed or work done in respect to property and performed prior to delivery to be sold by a retail merchant must however, be included in taxable gross receipts of the retail merchant.

(c) Persons engaging in repair services are servicemen with respect to the services which they render and retail merchants at retail with respect to repair or replacement parts sold.

(d) A serviceman occupationally engaged in rendering professional, personal or other services will be presumed to be a retail merchant selling at retail with respect to any tangible personal property sold by him, whether or not the tangible personal property is sold in the course of rendering such services. If, however, the transaction satisfies the four (4) requirements set forth in 6-2.5-4-1(c)(010), paragraph (1) [subsection (a) of this section], the gross retail tax shall not apply to such transaction.

Notably, only when the four requirements mentioned above are fulfilled, is a taxpayer entitled to the exemption pursuant to 45 IAC 2.2-4-2(a).

Believing that the vendors provided services, Taxpayer directed the Department to the following vendors:

1. Payments for Reports of Employee Background Checks.

The Department's audit assessed use tax on Taxpayer's payments to a vendor ("Vendor 1"), an investigative consumer reporting agency, for employee background checks. Taxpayer, to the contrary, claimed that Vendor 1 provides a service, and that, as a service, the payments were not subject to sales/use tax.

To support its protest, Taxpayer submitted a letter from Vendor 1 stating, in relevant part, that:

The labor cost to perform the service is greater than 90 [percent] of the cost to print the report. Our business is a professional, service business. [Vendor 1] is not required to pay sales tax on software or access. Our work is done by our in-house staff. [Vendor 1] pays sales tax on all equipment, supplies and materials used in the performance of the service.

Taxpayer, however, did not submit any documentation to substantiate the above statement.

Sales Tax Information Bulletin 8 (May 2002), in relevant part, states:

F. Sale of Miscellaneous Data:

The sale of statistical reports, graphs, diagrams or any other information produced or complied by a computer and sold or reproduced for sale in substantially the same form as it is so produced is considered to be the sale of tangible personal property unless the information from which such reports was compiled was furnished by the same person to whom the finished report is sold.

The charge for reports compiled by a computer exclusively from data furnished by the same person for whom the data is prepared is considered to be for a service and is not subject to sales or use tax unless it is part of a unitary transaction which is subject to sales or use tax.

In this instance, upon reviewing Vendor 1's sample report online, the report contained information, including, but not limited to, (1) Employment verification, (2) Reference verification, (3) Education verification, (4) Criminal/Civil records search, (5) Driving verification, (6) Drug testing, (7) Worker's compensation claims, (8)

Social search, and (9) Credit report. Vendor 1 compiled the information, in report formats, and sold the reports "in substantially the same form as [they are] so produced." Thus, Taxpayer did not contract with the vendor to perform and provide a service, i.e. collecting specific and customized information. Instead, Taxpayer purchased the completed products, after the vendor compiled and furnished standard information in the standard report formats. Pursuant to Sales Tax Information Bulletin 8, the reports of employees' background check are tangible personal property and, therefore, taxable.

Since Taxpayer did not pay sales tax at the time of the purchases, use tax is properly imposed.

2. Payments for Plant Maintenance Fees.

The Department's audit assessed use tax on Taxpayer's payments for monthly plant maintenance fees. Taxpayer maintained that the payments were for plant maintenance service provided by a floral company ("Vendor 2"). Thus, Taxpayer maintained that, as a service, the charges were not subject to sales/use tax.

To support its protest, Taxpayer submitted a letter from Vendor 2 stating, in relevant part, that:

We provided plant maintenance on plants in the office area and charged a weekly labor
Charge of $20.00 and billed monthly a total of $80.00.
The plants were sold to [Taxpayer] originally but there was no charge
Included for future maintenance of the plants.

In this instance, Vendor 2 sold Taxpayer plants, tangible personal property, and provided regular maintenance. At the hearing, Taxpayer indicated that Vendor 2's maintenance service included watering the plants and applying fertilizer, the latter being tangible personal property. Taxpayer, however, did not provide any documentation demonstrating that all the four requirements outlined in 45 IAC 2.2-4-2(a) were met. Since Vendor 2 did not separate the charge of the sale of tangible personal property from the charge of the plant maintenance service or document that tangible personal property was no more than ten percent of the total charge, this is a unitary retail transaction subject to Indiana sale/use tax.

Since Taxpayer did not pay sales tax at the time of the purchases, use tax is properly imposed.

3. Payment for On-line Hosting System.

The Department's audit assessed use tax on Taxpayer's payments for online hardware/software hosting and maintenance provided by Vendor 3 for those years. Taxpayer only protested the assessment concerning the "Hosting Fee."

Taxpayer asserted that it paid a monthly service fee for web-hosting and storage. Taxpayer further explained that it "uses the on-line hosting service to store its data related to engineering, sales, raw materials, inventory, production tracking, costing, shipping, purchasing, human resources, and accounting." Thus, Taxpayer maintained that "[t]he monthly fee provides access to the server via Internet access and provides the applications to the taxpayer, including all server-side hardware, databases, system infrastructure, server upgrades, backups, security, and system maintenance."

45 IAC 2.2-4-27, in pertinent part, states:

(a) In general, the gross receipts from renting or leasing tangible personal property are taxable. This regulation [45 IAC 2.2] only exempts from tax those transactions which would have been exempt in an equivalent sales transaction.

...

(c) In general, the gross receipts from renting or leasing tangible personal property are subject to tax. The rental or leasing of tangible personal property constitutes a retail transaction, and every lessor is a retail merchant with respect to such transactions. The lessor must collect and remit the gross retail tax or use tax on the amount of actual receipts as agent for the state of Indiana. **The tax is borne by the lessee**, except when the lessee is otherwise exempt from taxation.

(d) The rental or leasing of tangible personal property, by whatever means effected and irrespective of the terms employed by the parties to describe such transaction, is taxable.

(1) Amount of actual receipts. The amount of actual receipts means the gross receipts from the rental or leasing of tangible personal property without any deduction whatever for expenses or costs incidental to the conduct of the business. The gross receipts include any consideration received from the exercise of an option contained in the rental of lease agreement; royalties paid, or agreed to be paid, either on a lump sum or other production basis, for use of tangible personal property; and any receipts held by the lessor which may at the time of their receipt or some future time be applied by the lessor as rentals.

(2) Rental or lease period. For purposes of the imposition of the gross retail tax or use tax on rental or leasing transactions, each period for which a rental is payable shall be considered a complete transaction. In the case of a weekly rate, each week shall be considered a complete transaction. In the case of a continuing lease or contract, with or without a definite expiration date, where rental payments are to be made monthly or on some other periodic basis, each payment period shall be considered a completed transaction.

...

(4) Supplies furnished with leased property. A person engaged in the business of renting or leasing tangible personal property is considered the consumer of supplies, fuels, and other consumables which are

furnished with the property which is rented or leased. (**Emphasis added**).

In this instance, Taxpayer's documentation stated that it is the sole and exclusive owner of all its data stored in Vendor 3's server and databases. Taxpayer's documentation further stated, in relevant part, that:

Hosting Fee

The Hosting Fee covers the monthly cost of providing the application to the customer, including all server-side hardware, databases, system infrastructure, server upgrades, backups, security, and system maintenance.

Since the Hosting Fee covers Taxpayer's use of "all server-side hardware, databases, system infrastructure, server upgrades, backups, security, and system maintenance," and Taxpayer remains the sole owner of its data, Taxpayer has leased Vendor 3's tangible personal property (namely server-side hardware and system infrastructure) to store its data. Thus, the gross receipts from renting or leasing tangible personal property are subject to sales/use tax pursuant to the above mentioned regulation.

Pursuant to 45 IAC 2.2-4-27(c), the tax is borne by the lessee, i.e. Taxpayer. Since Taxpayer did not pay sales tax at the time of the retail transaction, the use tax is properly imposed.

4. Payment for Equipment Maintenance Agreements.

Taxpayer stated that it contracted with three (3) vendors ("Vendor 4," "Vendor 5," and "Vendor 6") to provide periodic inspections, cleaning, and preventive maintenance for the copiers in its offices. Taxpayer further asserted that those maintenance and service agreements had no certainty of transfer of tangible personal property. Thus, Taxpayer maintained that its vendors provided services, which were not subject to Indiana sales/use tax.

Upon reviewing Taxpayer's contract with Vendor 4, the contract, in relevant part, stated that "Contract includes: drum, toner, developer parts, labor, travel, cleanings, preventive maintenance." Thus, Vendor 4's agreement, contradicting Taxpayer's statement, demonstrated that tangible personal property, such as drum, toner, and developer parts, will be provided. Thus, Vendor 4's charges for Taxpayer's use of the copier were subject to sales/use tax.

Upon reviewing Taxpayer's contract with Vendor 5, the contract, in relevant part, stated that:

Price plan: Maintenance And Supplies

...

GENERAL TERMS:

...

4. Basic Services. [Vendor 5] will provide the following Basic Services under an express warranty or maintenance agreement []:

A. Repairs & Parts. [Vendor 5] will make repairs and adjustments necessary to keep Equipment in good working order....

Thus, Vendor 5's agreement, contradicting Taxpayer's statement, also demonstrated that tangible personal property will be provided. While Vendor 5's invoices stated that some Indiana sales tax was included in the monthly billing statement, the Department correctly assessed the deficiency which Vendor 5 did not collect concerning Taxpayer's use of the copier.

Finally, Taxpayer did not provide any documentation concerning Vendor 6. Thus, the Department is not able to agree that Taxpayer has met its burden demonstrating that Vendor 6 provided a service.

In short, Taxpayer's documentation demonstrated that it purchased equipment maintenance agreements, which the vendors transferred tangible personal property to keep the equipment in good working order. Thus, those maintenance agreements were subject to sales/use tax.

C. Credits for Overpayments of Sales Tax on Selected Purchases.

Taxpayer claimed that, within the selected sample, it erroneously paid sales tax on several purchases of tangible personal property. The Department's audit, however, should have, but failed to give Taxpayer the credits. Specifically, Taxpayer mentioned that, within the selected sample, there were purchases of tangible personal property, including, but not limited to, stretch wrap, steel strapping, safety gloves, glasses, earplugs, repair and replacement parts for welding equipment used in the sub-assembly department, welding rod and wire used in assembly operations, and various repairs to manufacturing machinery, tools and equipment, which the Department did not give Taxpayer the credits for sales tax mistakenly paid to the supplier.

Upon reviewing Taxpayer's documentation, the Department agrees that Taxpayer was entitled to the exemption on its purchases of safety glasses and ear plugs as discussed in Subpart A. 4.

Additionally, Taxpayer's documentation also demonstrated that it was entitled to exemption afforded in IC § 6-2.5-5-9 and 45 IAC 2.2-5-16 for seven (7) purchases.

Stratum	Date	Invoice #	Vendor Amount
5	04/27/06	xxxxxx-xx	xxxxxx. xxxxxx
5	09/08/06	xxxxxx-xx	xxxxxx. xxxxxx
5	03/09/07	xxxxxx-xx	xxxxxx. xxxxxx

5	05/18/07	xxxxxx-xx	xxxxxx. xxxxxx
5	08/10/07	xxxxxx-xx	xxxxxx. xxxxxx
5	10/05/2007	xxxxxx-xx	xxxxxx xxxxxx
6	07/28/06	xxxxxx-xx	xxxxxx. xxxxxx

Thus, Taxpayer is entitled to credits for sales tax which it mistakenly paid to its vendors on those seven (7) transactions. The Department will recalculate Taxpayer's tax liability accordingly in a supplemental audit.

The Department, however, is not able to agree that Taxpayer demonstrated that (1) the repair and replacement parts for welding equipment (used in the sub-assembly department), (2) welding rod and wire (used in assembly operations), and (3) various repairs to manufacturing machinery, tools, and equipment were directly used in its manufacturing production. Thus, Taxpayer is not entitled to the manufacturing exemption on those purchases and the sales tax was properly paid.

In short, Taxpayer is entitled to credits for the sales tax, which it erroneously paid to its vendors, on its purchases of the above seven (7) wrapping materials, safety glasses, and ear plugs, because Taxpayer has demonstrated that it was entitled to manufacturing exemption.

FINDING

Taxpayer's protest is sustained in part and denied in part. Taxpayer is entitled to manufacturing exemption for its purchases of the safety glasses and earplugs as discussed in Subpart A. 4. and Subpart C. Taxpayer is also entitled to manufacturing exemption for its purchases of the wrapping materials listed in Subpart C. The remainder of Taxpayer's purchases, however, was subject to sales/use tax. The Department will recalculate Taxpayer's tax liability in a supplemental audit.

II. Tax Administration – Negligence Penalty.

DISCUSSION

Taxpayer also protests the imposition of the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1(a), the Department may assess a ten (10) percent negligence penalty if the taxpayer:

(1) fails to file a return for any of the listed taxes;

(2) fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment;

(3) incurs, upon examination by the department, a deficiency that is due to negligence;

(4) fails to timely remit any tax held in trust for the state; or

(5) is required to make a payment by electronic funds transfer (as defined in IC 4-8.1-2-7), overnight courier, or personal delivery and the payment is not received by the department by the due date in funds acceptable to the department.

45 IAC 15-11-2(b) further states:

"Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive a negligence penalty as provided in 45 IAC 15-11-2(c), in part, as follows:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;

(2) judicial precedents set by Indiana courts;

(3) judicial precedents established in jurisdictions outside Indiana;

(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;

(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

In this instance, Taxpayer's protest of Part I is sustained in part. Thus, the Department will remove the assessment of the negligence penalty on the sustained items accordingly. Also, Taxpayer is given credits for sales tax, which it mistakenly paid to its vendors as discussed in Part I. C. Thus, Taxpayer's negligence penalty

will be reduce and adjusted to reflect the credits on those sustained items accordingly.

For the remaining items which are denied in this protest, Taxpayer did not provide sufficient documentation establishing that its failure to pay tax or timely remit tax was due to reasonable cause and not due to negligence. The negligence penalty on those items will stay put.

FINDING

Taxpayer's protest of the negligence penalty is respectfully denied.

SUMMARY

For the reasons discussed above, Taxpayer's protest is sustained in part and denied in part. Taxpayer is entitled to manufacturing exemption for its purchases of the safety glasses, earplugs, and seven (7) wrapping materials. The Department will remove the assessment or give credits to taxpayer regarding those purchases. The remainder of Taxpayer's purchases, however, was subject to sales/use tax. Additionally, Taxpayer's protest of the negligence penalty is respectfully denied. The Department will recalculate Taxpayer's tax liability in a supplemental audit.

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